

INITIATE COVERAGE

Foxconn Industrial Internet (601138 CH)

Server ODM Giant To Remain A Key Winner Of The Gen AI Investment Trend

FII is one of the largest AI server ODMs globally. Thanks to its extensive client coverage and its capabilities to offer full-stack solution for AI data centres, FII has managed to capture a quarter of the global AI server's market share and achieved significantly higher margins than its peers. At an undemanding valuation of 9.1x 2024F PE, we believe FII is currently one of the best investment targets in the GenAI value chain. Initiate coverage with BUY and a target price of Rmb18.90.

INITIATE COVERAGE

- **A leading AI server manufacturer with the most extensive coverage across the value chain.** Foxconn Industrial Internet (FII) is one of the largest AI server manufacturers and ODMs globally, responsible for producing a quarter of the world's high-end data centre servers in 2023. We believe FII is one of the best positioned names globally to capture the investment in generative AI (GenAI) from cloud applications, thanks to its extensive exposure across the AI data centre supply chain, and its ability to offer full-stack AI data centre solutions.
- **The AI-related business is likely to register robust growth in 2023-25,** driven by robust investments from CSPs, ramp-up of data centre chip production and a surge in the use of GenAI applications. We expect FII's AI-related business to grow 39.9%/107.1%/57.6% yoy in 2023-25 to Rmb56b/Rmb117b/Rmb184b (Figure 3), contributing to 12.1%/21.3%/28.9% of total revenue during the respective periods.
- **The networking equipment business will also benefit from the boom in cloud infrastructure investment.** FII's communication network equipment business consists of network equipment, telecom equipment, and the precision component business. The current boom in cloud infrastructure investment is driving a new round of product upgrades for high-speed switches (eg from 400G to 800G and 1.6T switches in 2023-25 driven by the rapid upgrade of data centres) and high-speed routers, which can drive a meaningful recovery in the segment's sales and profitability from 2024 onwards.
- **Concerns over US export restriction risks are overdone.** FII's AI business (12% contribution to total revenue) has 10-20% exposure to China (1.3-2.6% of total revenue), which will be affected by the US export restrictions. However, we expect minimal impact in 2024 as the robust demand backlog from overseas should be more than enough to offset the shortfall from China.
- **Initiate coverage with BUY and a target price of Rmb18.90,** based on 13.5x 2024F PE, on a par with its historical forward mean. After the >50% share price correction from the peak, we believe the current valuation of 9.1x 2024F PE (~1SD below historical forward mean) has already discounted market's concerns of a slowdown in growth beyond 2024, as well as risks related to geopolitical issues. We also believe its valuation is undemanding considering our estimates of a 18% earnings CAGR in 2023-25.

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KEY FINANCIALS

Year to 31 Dec (Rmbm)	2021	2022	2023F	2024F	2025F
Net turnover	439,557	511,850	465,409	549,461	637,032
EBITDA	24,009	25,022	28,014	35,888	42,708
Operating profit	20,031	20,211	23,379	30,207	35,981
Net profit	20,010	20,073	21,568	27,893	33,250
Net profit (adj.)	18,581	18,410	21,568	27,893	33,250
EPS (fen)	94.3	92.7	108.6	140.5	167.4
P/E (x)	13.5	13.7	11.7	9.1	7.6
P/BV (x)	2.1	2.0	1.8	1.6	1.4
EV/EBITDA (x)	15.7	15.0	13.4	10.5	8.8
Dividend yield (%)	3.9	4.3	4.3	5.5	6.6
Net margin (%)	4.6	4.6	3.9	4.6	5.1
Net debt to equity (%)	(22.6)	(12.0)	(36.0)	(15.5)	(36.5)
Interest cover (x)	29.1	35.6	46.8	44.8	43.5
ROE (%)	18.0	16.2	16.1	18.8	20.0
Consensus net profit	-	-	23,697	28,867	33,585
UOBKH/Consensus (x)	-	-	0.91	0.97	0.99

Source: Bloomberg, UOB Kay Hian

BUY

Share Price	Rmb12.72
Target Price	Rmb18.90
Upside	48.6%

COMPANY DESCRIPTION

Foxconn Industrial Internet operates as a communication network equipment development company. It develops and sells network switches, routers, wireless devices, web servers, set top boxes, smart home gateways, and other products. The company also manufactures storage equipment.

STOCK DATA

GICS sector	EMS/ODM
Bloomberg ticker:	601138 CH
Shares issued (m):	19,866
Market cap (Rmb):	252,694
Market cap (US\$m):	35,591
3-mth avg daily t'over (US\$m):	181.2

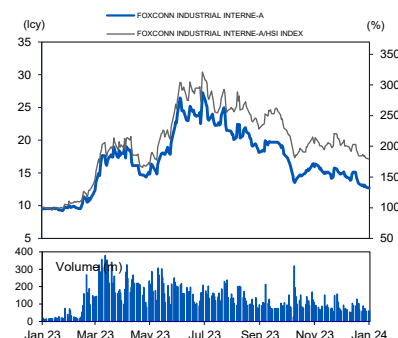
Price Performance (%)

52-week high/low	Rmb27.3/Rmb9.2			
1mth	3mth	6mth	1yr	YTD
(13.9)	(28.9)	(53.3)	34.9	(15.9)

Major Shareholders

	%
China Galaxy Enterprise Ltd.	36.72
FY23 NAV/Share (Rmb)	6.92
FY23 Net Debt/Share (Rmb)	2.53

PRICE CHART



Source: Bloomberg

ANALYST(S)

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STOCK IMPACT

- **We expect a 18% net profit CAGR in 2023-25.** We are expecting FII to register a revenue growth of -9.1%/+18.1%/+15.9% yoy in 2023-25 respectively, primarily driven by a +39.9%/+107.1%/+57.5% yoy growth in AI ODM business (contributing to 12.1%/21.3%/28.9% of total revenue). Thanks to the improvements in product mix, we expect margins to expand by 1.2ppt/0.5ppt/0.1ppt yoy to 8.5%/9.0%/9.1% in 2023-25 respectively, driving a 18% net profit CAGR during the period.

VALUATION/RECOMMENDATION

- **Initiate coverage with BUY; target price of Rmb18.90 based on 13.5x 2024F PE, on a par with its historical one-year forward mean.** FII's share price has corrected by more than 50% from the peak in mid-23, as the market is concerned about the sustainability of cloud investment's growth and geopolitical risks from the US' export restrictions. However, we believe that FII's current valuation of 9.1x 2024F PE (<1SD below historical forward mean) has already discounted market's concerns of a slowdown in growth beyond 2024, as well as risks related to geopolitical issues. We are also expecting investment in cloud to remain elevated in the coming three years, driven by robust investment into GenAI, as well as the accelerating adoption of GenAI enabled by edge-AI's penetration.

REVENUE BREAKDOWN OF FII'S KEY BUSINESS SEGMENTS

	2022	2023	2024	2025
Revenue (Rmbm)	511,850	465,409	549,461	637,032
Communication and network Equipment	296,178	272,720	279,056	285,205
Network equipment	124,550	92,400	104,832	115,839
Telecom equipment	15,179	12,320	13,574	15,016
Apple business	156,449	168,000	160,650	154,350
Cloud Service Equipment	212,444	189,116	266,480	347,520
EMS	121,093	88,633	99,613	108,117
AI ODM	40,364	56,463	116,919	184,117
General ODM	52,293	44,020	49,949	55,286
Robots and technology services	1,912	2,257	2,609	2,991
yoy growth (%)				
Revenue	16.4	(9.1)	18.1	15.9
Communication and network Equipment	14.4	(7.9)	2.3	2.2
Network equipment	23.3	(25.8)	13.5	10.5
Telecom equipment	5.3	(18.8)	10.2	10.6
Apple business	9.0	7.4	(4.4)	(3.9)
Cloud Service Equipment	19.6	(11.0)	40.9	30.4
EMS	n.a.	(26.8)	12.4	8.5
AI ODM	n.a.	39.9	107.1	57.5
General ODM	n.a.	(15.8)	13.5	10.7
Robots and technology services	13.4	18.1	15.6	14.6

Source: Bloomberg, UOB Kay Hian

BREAKDOWN OF FII'S AI BUSINESS

	2023	2024	2025
Revenue	56,463	116,919	184,117
AI ODM	51,374	104,325	163,878
GPU Module	4,686	9,372	13,064
GPU Baseboard	403	3,222	7,175
(%) of total revenue	12.1	21.3	28.9
AI ODM	11.0	19.0	25.7
GPU Module	1.0	1.7	2.1
GPU Baseboard	0.1	0.6	1.1
Gross profit	6,400	13,312	19,737
AI ODM	5,128	10,163	14,677
GPU Module	1,172	2,343	3,266
GPU Baseboard	101	805	1,794
(%) of total gross profit	16.2	27.1	34.0
AI ODM	13.0	20.7	25.3
GPU Module	3.0	4.8	5.6
GPU Baseboard	0.3	1.6	3.1

Source: UOB Kay Hian

PROFIT & LOSS

Year to 31 Dec (HK\$m)	2020	2021F	2022F	2023F
Net turnover	511,850	465,409	549,461	637,032
EBITDA	25,022	28,014	35,888	42,708
Depreciation & amortization	(4,811)	(4,636)	(5,682)	(6,727)
EBIT	20,211	23,379	30,207	35,981
Total other non-operating income	1,048	-	-	-
Associate contributions	-	-	-	-
Net interest income/(expense)	704	598	801	982
Pre-tax profit	21,963	23,977	31,008	36,963
Tax	(1,879)	(2,398)	(3,101)	(3,696)
Minorities	(11)	(11)	(14)	(17)
Net profit	20,073	21,568	27,893	33,250
Net profit (recurrent)	18,410	21,568	27,893	33,250

CASH FLOW

Year to 31 Dec (HK\$m)	2020	2021F	2022F	2023F
Operating	15,366	56,746	(4,668)	64,217
Pre-tax profit	21,963	23,977	31,008	36,963
Tax	(1,879)	(2,398)	(3,101)	(3,696)
Depreciation/amortization	4,811	4,636	5,682	6,727
Associates	-	-	-	-
Working capital changes	(12,174)	31,586	(37,456)	25,205
Non-cash items	2,645	(1,054)	(801)	(982)
Other operating cashflows	1,877	(456)	-	-
Investing	(15,308)	(11,340)	(11,340)	(11,340)
Capex (growth)	(8,093)	(11,340)	(11,340)	(11,340)
Investments	(6,918)	-	-	-
Proceeds from sale of assets	47	-	-	-
Others	(342)	-	-	-
Financing	(14,068)	(8,324)	(9,983)	(12,964)
Dividend payments	(11,090)	(10,324)	(9,983)	(12,964)
Issue of shares	-	-	-	-
Proceeds from borrowings	148,245	150,000	150,000	150,000
Loan repayment	(148,264)	(148,000)	(150,000)	(150,000)
Others/interest paid	(2,959)	-	-	-
Net cash inflow (outflow)	(14,010)	37,082	(25,991)	39,913
Beginning cash & cash equivalent	81,071	69,167	106,249	80,257
Changes due to forex impact	2,106	-	-	-
Ending cash & cash equivalent	69,167	106,249	80,257	120,170

BALANCE SHEET

Year to 31 Dec (HK\$m)	2020	2021F	2022F	2023F
Fixed assets	15,937	21,812	27,035	31,606
Other LT assets	19,311	20,860	21,295	21,337
Cash/ST investment	69,167	106,249	80,257	120,170
Other current assets	179,773	131,938	220,887	174,401
Total assets	284,188	280,858	349,475	347,514
ST debt	50,498	52,498	52,498	52,498
Other current liabilities	98,678	82,692	134,185	112,904
LT debt	3,485	3,485	3,485	3,485
Other LT liabilities	2,194	2,194	2,194	2,194
Shareholders' equity	128,975	139,621	156,730	176,034
Minority interest	358	369	383	400
Total liabilities & equity	284,188	280,858	349,475	347,514

KEY METRICS

Year to 31 Dec (%)	2020	2021F	2022F	2023F
Profitability				
Gross margin	7.3	8.5	9.0	9.1
Pretax margin	4.3	5.2	5.6	5.8
Net margin	3.9	4.6	5.1	5.2
ROA	7.3	7.6	8.9	9.5
ROE	16.2	16.1	18.8	20.0
Growth				
Turnover	16.4	(9.1)	18.1	15.9
Gross profit	1.8	6.2	24.7	17.9
Pre-tax profit	(1.6)	9.2	29.3	19.2
Net profit	0.3	7.4	29.3	19.2
Net profit (adj)	(0.9)	17.2	29.3	19.2
EPS	(0.5)	7.4	29.3	19.2
Leverage				
Debt to total capital	3.0	3.0	2.4	2.4
Debt to equity	6.5	6.0	5.4	4.8
Net debt to equity	(12.0)	(36.0)	(15.5)	(36.5)
Interest cover (x)	35.6	46.8	44.8	43.5